SPECIAL FEATURE
The Low-Fare Evolution

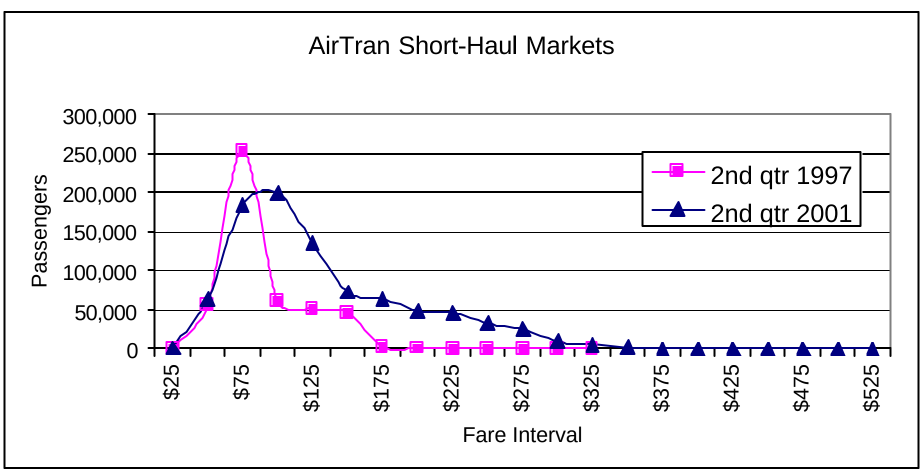
For many years, low-fare competition primarily disciplined price in dense, short-haul markets. An infusion of low-fare seats in this type of market generally results in impressive market stimulation. And unless the market entered is a discretionary market that already has competitive fares, a precipitous drop in the average fare usually accompanies the increase in traffic. These two effects have been demonstrated numerous times in past Special Features.

Over the past few years, new entrants and low-fare competitors have demonstrated a willingness to expand the conventional approach to new entry. Low-fare service is spreading into smaller and longer-haul markets, and a few low-fare carriers are also now competing more aggressively for business passengers who are willing to pay a premium for last-minute travel. The latter is the focus of this Special Feature. In exchange for those premium fares, business travelers expect additional services, which may include a roomier business compartment, advance seating assignments, or a frequent flyer program. Additionally, convenient connections across a hub exponentially increase the number of origin and destination markets served by the carrier, and accessible to the traveler. AirTran Airways offers all three of these services, as well as their A2B Corporate Travel Program. Frontier Airlines has entered the low-fare carrier business arena as well, with their Business Travel Program. Both airlines were among Entrepreneur Magazine's most recent picks for "Best Low-Fare Carrier."

Notably, AirTran Airways has positioned itself as an affordable business alternative rather than solely as a purveyor of rock bottom fares. AirTran originally started business under the more traditional low-fare model, but over the course of time has expanded into smaller business centers such as Milwaukee, Wichita and Akron. AirTran also serves a number of large business centers such as New York, Dallas, Philadelphia, and Washington, DC. All destinations receive nonstop service to AirTran's Atlanta hub.

Changes in AirTran Traffic and Fares

Customer response to AirTran's focus on business services seems positive based on the charts below. AirTran's once simple fare structure has developed into a more complex structure that attests to the airline's growing pricing and marketing sophistication.



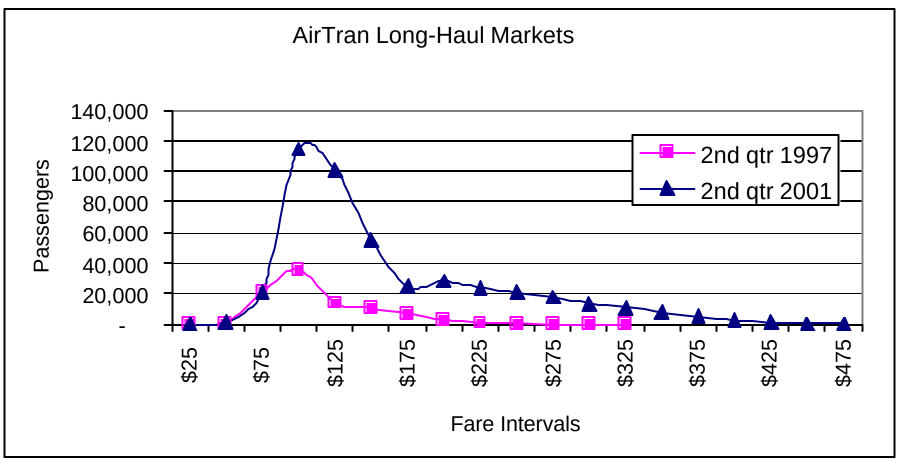
AirTran passengers in short-haul markets have increased by 88% since 1997, from 475,000 to 890,000, in spite of a large increase in average fares. Short-haul average fares rose from $76 to

$119 each way – a 76% change. Average short-haul stage length remained relatively unchanged. In 1997, a clear majority of AirTran passengers paid between $51 and $75 each way. In 2001, the peak was evenly spread between $51 and $100 each way. In addition to the shift in leisure fares, more price discrimination in both restricted and unrestricted coach fares and the introduction of new business fares have resulted in a small group of passengers paying high fares that didn't exist in 1997.

According to AirTran data, the % of short-haul passengers buying unrestricted coach and business class tickets is around 12. So while the introduction of new business fares and the increase in unrestricted coach fares have contributed to the overall increase in AirTran's average fares, it is the 68% increase in restricted coach fares that is primarily responsible for the overall average fare increase.

AirTran O&D Traffic by Fare Class: Short-Haul Markets

	97/2 Passengers	97/2 Avg Fare	01/2 Passengers	01/2 Avg Fare	Passenger Change	Fare Change
Restricted Coach	370,920	$64	928,990	$108	150%	68%
Unrestricted Coach	130,650	$116	80,580	$212	(38%)	84%
Business Class			41,110	$236	-	-



AirTran passenger numbers in long-haul markets have more than quadrupled since 1997, a result of the carrier's aggressive expansion in connecting markets. As in short-haul markets, average fares have increased by half – from $101 each way to $152 – with little change in average stage length. In long-haul markets the volume of traffic grew dramatically in the $25 fare interval with the most passengers and in those immediately above it, while passenger levels at the lowest restricted fare intervals remained constant. As a result, AirTran's restricted coach passenger fares are driving fare increases in long-haul markets. Increases in restricted fares and the introduction of business fares have obviously contributed as well. Ten percent of AirTran's long-haul traffic bought restricted coach or business fares.

AirTran O&D Traffic by Fare Class: Long-Haul Markets

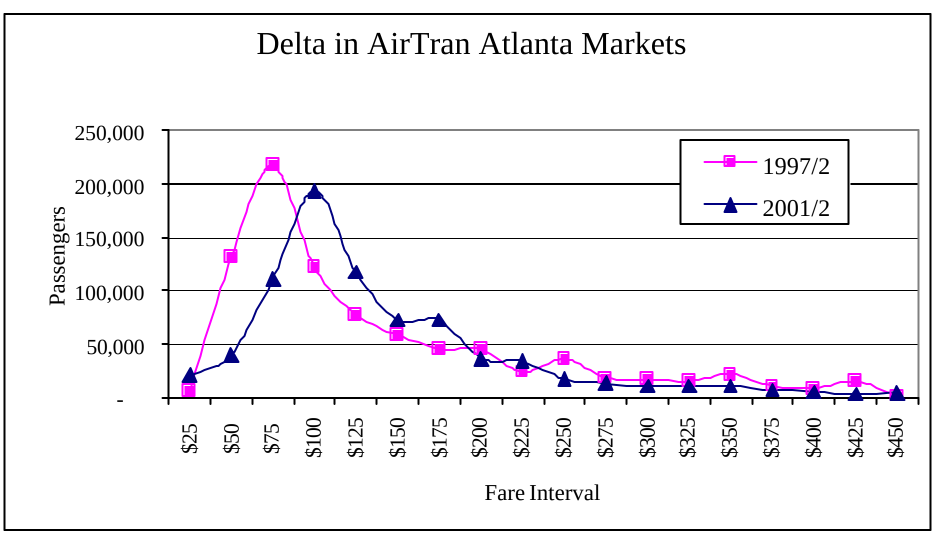
	97/2 Passengers	97/2 Avg Fare	01/2 Passengers	01/2 Avg Fare	Passenger Change	Fare Change
Restricted Coach	95,900	$88	580,200	$140	430%	59%
Unrestricted Coach	27,760	$150	41,690	$267	50%	78%
Business Class			15,830	$307	-	-

Overall, it seems that AirTran is making a successful bid at business travelers throughout its network. However, the vast majority of AirTran's traffic is still comprised of passengers flying on restricted low fares. Upward shifts in those restricted fares, rather than the addition of higher business-class fares, is the primary driving force behind recent increases in AirTran's average fares.

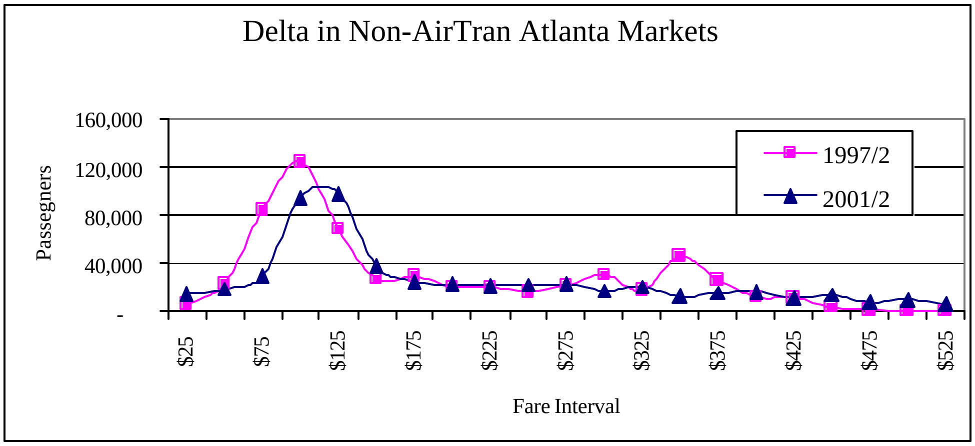
Network Carrier Response

In the past, major network carrier response to low-fare entry has ranged from completely ignoring the new entrant to massive dumping of low-fare seats.   Encroachment into high-revenue business traffic represents an incursion into the major carrier's primary revenue base. In the case of AirTran, we examined how Delta's fares in Atlanta short-haul markets have changed over time.

In local Atlanta markets where Delta competed with AirTran in both periods, Delta continued to carry a number of passengers at fares above $275 – AirTran's highest significant fare increment in comparable short-haul markets. One change over time is the disappearance of passenger 'spikes' at particular high-fare levels. While this could represent a competitive response to AirTran's business fares, it is more likely a reflection of the major carrier's increasing use of corporate contract fares. Coincidentally, Delta's low-end leisure fare peak has shifted to the right by $25, corresponding to the shift in AirTran's leisure fare peak.



The exact same pattern can be seen in Delta's Atlanta markets where it does not face low-fare competition: a slight shifting of the leisure-fare peak, and the disappearance of high-fare spikes.



AirTran does, however, seem to be maintaining its ability to provide price discipline in Atlanta markets. Delta's average fare in markets without AirTran competition in the second quarter of 1997 was 20% higher than in markets with AirTran competition. In 2001, the fare spread between the two market sets had increased to 23%. Delta's average fare in AirTran markets in the second quarter 2001 was $177, compared to $196 in markets without AirTran competition. And in spite of its fare increases, AirTran continues to offer an extremely competitive travel alternative for passengers. AirTran's short-haul average fare of $119 is still 49% lower than Delta's in the same group of markets.

This brief analysis provides interesting insight into how the competitive dynamics between low-fare new entrants and their incumbent major network carrier competitors change over time as the new entrant matures in the marketplace and its incumbent competitors adjust to its presence. While AirTran clearly continues to provide competitive price discipline in the markets it serves, the nature of this price discipline changes over time as the business models of all competitors in the market adapt to the new competitive dynamic. This example perhaps underscores the importance of new entry in maintaining a dynamic, competitive, and innovative airline industry that is so important to economic growth.